BUSINESS/NONBUSINES INCOME
When is Income Business Income?

I. INTRODUCTION

Kentucky Revised Statutes 141.040(1) imposes an income tax on "[e]very corporation doing business in the state[,]" except for nine types of corporations expressly excluded in subsections (a) – (h)[1]. (Certain financial institutions, certain savings and loan associations, banks for cooperatives, production credit associations, insurance corporations, corporations exempt under Section 501 of the Internal Revenue Code, religious, educational, charitable or like corporations not organized or conducted for pecuniary profit, and corporations whose only owned or leased property located in this state is located at the premises of a printer with which it has contracted for printing.)

"**Doing business in this state**" is defined in KRS 141.010(25) as including: (a) being organized under the laws of this state; (b) having a commercial domicile in this state; (c) owning or leasing property in this state; (d) having one or more individuals performing services in this state; (e) maintaining an interest in a pass-through entity doing business in this state; (f) deriving income from or attributable to sources within this state, including deriving income directly or indirectly from a trust doing business in this state, or deriving income directly or indirectly from a single-member limited liability company that is doing business in this state and is disregarded

[1] Subsection (i) excluding S corporations for tax years beginning after December 31, 2004 and before January 1, 2007, is not applicable in most cases for audit purposes because of the four year limitation on audits. See KRS 141.210(2).

as an entity separate from its single member for federal income tax purposes; or (g) directing activities at Kentucky customers for the purpose for selling them goods or services. The statute concludes by stating:

> "Nothing in this subsection shall be interpreted in a manner *that goes beyond the limitations imposed and protections provided by the United States Constitution or Pub[lic] L[aw] No. 86-272*." (emphasis supplied)

The subject matter of this Revenue Training course focuses on determining what income received by a multistate business enterprise doing business both in and outside of Kentucky is subject to Kentucky's corporation income tax in accordance with Kentucky law and within the limitations and protections provided by the United States Constitution.

II. CONSTITUTIONAL LIMITATIONS ON TAXING INCOME OF MULTISTATE BUSINESSES.

The United States Constitution places limitations on the ability of the states to tax the income of a multistate business enterprise, forbidding them to tax the "extraterritorial values" unrelated to a corporate taxpayer's business activities within the taxing state. A state may, however, tax an apportioned share of the income generated, which represents the fiscal relationship between the state and the corporate taxpayer doing business there. In other words, in order to meet the standard set by the United States Constitution for taxing a corporate taxpayer's multistate business enterprise, the taxing power exerted by Kentucky must bear a fiscal relationship to the protection, opportunities, and benefits provided by Kentucky to the corporate taxpayer during the tax year. The corporate taxpayer's income representing Kentucky's apportioned share subject to Kentucky's corporation income tax is known as "**business income**." **Non-**

business income," on the other hand, is not subject to tax unless it is derived from property located or having a situs in Kentucky, as discussed below.

States have found it difficult to determine their fair share of the income generated by a multistate business enterprise since the emergence of railroad, telegraph, and express companies during the Industrial Revolution in the 19th century. A state often cannot tax its fair share of the value generated by a multistate business enterprise by simply taxing the capital found within its borders. This is because the whole of the enterprise is generally more valuable than the sum of its parts. As the United States Supreme Court observed in 1876 when describing railroad companies, "[t]he track of the road is but one track from one end of it to the other, and except in its use as one track, is of little value. State Railroad Tax Cases, 92 U.S. 575, 608 (1875).

The Court dealt with this problem by shifting the inquiry from "geographic accounting" to the determination of a taxpayer's business unit, often referred to as **"the unitary business principal."** If the income the state wished to tax was derived from a "unitary business" operated both within and outside the state, the state could tax an apportioned share of the income of that business enterprise, instead of isolating the income attributable to property or activities within the state. Conversely, if the income the state wished to tax derived from a discreet business enterprise not connected to the activities conducted in the state, then the state could not tax even an apportioned share of that value. Thus, in the railroad cases, the United States Supreme

Court held that a state was not required to assess trackage within its borders according to its value there, but instead, it was permitted to ascertain the value of the whole track and apportion the value within its borders by its relative length to the whole.

Later, the Court applied this same principle to other multistate business enterprises lacking the "physical unity" of rails or wires, but which exhibited the "same unity in the use of the entire property for the specific purpose . . . . [with] the same elements of value arising from such use." Adams Express Co. v. Ohio, State Auditor, 165 U.S. 194 (1897). Since then, and as American enterprise has evolved, the Court has consistently applied the unitary business principle when determining state taxation of a variety of multistate business enterprises. In each case, the Court determined whether "intrastate and extrastate activities formed part of a single unitary business" or instead, whether the out-of-state values a state sought to tax were derived from an "unrelated business activity which constitute[ed] a discreet business enterprise." Meadwestvaco Corp. v. Illinois Dept. of Revenue, 553 U.S. 16, 25 (2008)(internal citations omitted).

Kentucky need not isolate the intrastate income-producing activities from the rest of the business, but may tax an apportioned sum of the corporation's multistate business if the business is unitary.

Conversely, income derived from unrelated business activity which constitutes a discreet business enterprise unrelated to the corporation's activities within Kentucky is not included as part of the corporation's income subject to Kentucky's corporation income tax.

Thus, once it is evident a corporate taxpayer has done some business in Kentucky, when determining whether income is classified as business income, the auditor must next determine whether the taxpayer's intrastate and out-of-state activities formed part of a single unitary business. Income derived from a taxpayer's unitary business is business income, regardless of whether the income-producing activity occurred within or outside of Kentucky. Identifying a corporate taxpayer's unitary business is the key to determining its business income.

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III. THE UNITARY BUSINESS PRINCIPLE APPLIES WHEN DETERMINING THE BUSINESS INCOME OF A MULTISTATE BUSINESS ENTERPRISE, DESPITE THAT IT MAY NO LONGER BE UTILIZED TO JUSTIFY FILING ONE COMBINED CORPORATION INCOME TAX RETURN IN KENTUCKY.

It is important to note that historically (i.e. prior to 1996) a multistate business enterprise was able to utilize the unitary business principle to justify filing one combined corporation income tax return in Kentucky. Prior to 1996 the corporation income tax statutes (KRS 141.120 and 141.200) were construed by the Kentucky Supreme Court as authorizing a multistate business enterprise comprised of multiple corporations engaged in a unitary business to file a single combined income tax return. (GTE v. Revenue Cabinet, 889 S.W.2d 788 (Ky. 1994))

In 1996, the Kentucky General Assembly amended the law to prohibit the filing of a combined return under the unitary business concept. Instead, an approach similar

to the federal government's program allowing an affiliated group of corporations the privilege of making a "consolidated return" was adopted. (Internal Revenue Code §1501 et seq.) Under current law, in Kentucky an "affiliated group" (as that term is defined in KRS 141.200(9)(a)), is required to file a consolidated return in accordance with the provisions found in KRS 141.200(9)-(14). All other corporations not part of the affiliated group, but which are doing business in Kentucky, must file a separate return (except those exempt from taxation under KRS 141.040(1)(a)-(i)).

It is important to note that while a multistate business enterprise comprised of multiple corporations engaged in a unitary business may not file a single combined return for its unitary business, the unitary business principle remains applicable when determining the "business income" of a multistate business enterprise.

IV. "BUSINESS INCOME" AS DEFINED AND DETERMINED UNDER KENTUCKY LAW.

A. Business income of a multistate corporate taxpayer is apportioned.

A multistate business enterprise's business income is ***apportioned*** by the company to each state in which it does business based upon the amount of business done in the state. In Kentucky, apportionment is calculated using a formula set forth in KRS 141.120 (8) through (11). Similar to other states, this formula is based upon the amount of property, payroll, and sales in Kentucky as compared to a company's property, payroll, and sales everywhere. The United States Supreme Court has long deemed "formulas utilizing in-state aspects of interstate affairs[,]" appropriate for

apportioning income among the States for tax purposes. Northwestern States Portland Cement Company v. State of Minnesota, 358 U.S. 450 (1959).

This training course concentrates on how we determine business income, which will properly be apportioned to Kentucky. "Nonbusiness income" is ***allocated*** rather than apportioned. Although allocation is generally to the state in which the multistate business enterprise is domiciled, under some circumstances nonbusiness income is allocated to Kentucky.

Once "net income" is determined (as defined in KRS 141.010(13)), "taxable net income" is net income "as allocated and apportioned under KRS 141.120." KRS 141.010(14).

B. "Business income" and "nonbusiness income" are defined in KRS 141.120.

Kentucky Revised Statute 141.120(1)(a) defines "**business income**":

> **Income arising from transactions and activity in the regular course of a trade or business of the corporation and includes income from tangible and intangible property if the acquisition, management, or disposition of the property constitutes integral parts of the corporation's regular trade or business operations.**

All business income is **apportioned to Kentucky** in accordance with the apportionment formula set forth in KRS 141.120 subsections (8) through (11).

Subsection (e) defines "**nonbusiness income**":

> **" 'Nonbusiness income' means all income other than business income."**

Nonbusiness income is **allocated to Kentucky** as provided in KRS 141.120 subsections (4) through (7).

The definitions of "business income" and "nonbusiness income" under Kentucky law, like many other states' laws defining business income, were derived from the definitions provided under the Uniform Division of Income for Tax Purposes Act ("UDITPA"). The scope of Kentucky's definitions for business and nonbusiness income does not exceed the limits placed upon the states by the United States Constitution, as discussed in Part II above.

C. Regulation 103 KAR 16:060.

The Kentucky Department of Revenue has promulgated a regulation which provides guidance to taxpayers when determining whether net income is taxable because it is either business income subject to apportionment or nonbusiness income properly allocated to Kentucky. The definition of "business income" is key to determining whether income of a multistate enterprise should be apportioned to Kentucky. Regulation 103 KAR 16:060 clarifies that the statutory definition of "business

income" provided in KRS 141.120(1)(a) creates both a ***transactional test*** and a ***functional test*** for classifying income.

A corporate taxpayer's income is business income if it satisfies <u>either</u> the transactional or the functional test. Both tests do not have to be satisfied to declare income is business income. 103 KAR 16:060 §5.

1. The transactional test.

The ***transactional test*** arises from the first clause of the language in KRS 141.120(1)(a) defining business income, ***i.e. "income arising from transactions and activity in the regular course of a trade or business of the corporation[.]"*** This clause focuses on "transactions and activity" and their relationship to "the regular course of the taxpayer's trade or business." The controlling factor by which the transactional test identifies business income is the nature of the particular transaction that generates the income. To create business income, these "transactions and activity" must occur "in the regular course of the taxpayer's trade or business." Relevant considerations include the frequency and regularity of similar transactions, the former practices of the business, and the taxpayer's subsequent use of the income.

Most frequently-occurring transactions or activities will satisfy the test, although frequency of the income-producing transaction is not necessarily required. It is sufficient to classify a transaction or activity as being in the regular course of a trade or business, if it is reasonable to conclude transactions of that type are: (1) customary in the kind of business or trade being conducted, or (2) within the scope of what that kind of trade or business does. 103 KAR 16:060 §3(2)(a), (b).

On the other hand, if the income producing activity or transaction is not for the corporate taxpayer's trade or business, it is not business income regardless of whether the taxpayer frequently or customarily engages in the activities. 103 KAR 16:060 §3(2)(c).

Under the transactional test, business income includes:

(1) income from sales of inventory, property held for sale to customers, and services commonly sold by the trade or business; and

(2) income from the sale of property used in the production of business of a kind that is sold and replaced with some regularity, even if replaced less frequently than once a year. 103 KAR 16:060 §3(2)(d).

Income may be business income regardless of where the actual transaction or activity occurs (i.e within or without Kentucky), so long as the transaction or activity is one occurring in the regular course of the taxpayer's trade or business, part of which trade or business is conducted within Kentucky. 103 KAR 16:060 §3(1).

However, unprecedented, once-in-a-lifetime occurrences do not meet the transactional test because they do not occur in the regular course of any business.

2. The functional test.

The ***functional test*** arises from the second clause of the definition of "business income," found in KRS 141.120(1)(a), ***i.e. that business income "includes income from tangible and intangible property if the acquisition, management, or disposition of the property constitutes integral parts of the corporation's regular trade or business[,]"*** focuses on "property" and its relationship to "the taxpayer's regular trade or business operations." The property may be tangible or intangible.

The functional test may be applied to any type of property (e.g. tangible or intangible property, real or personal property). 103 KAR 16:060 §4(6).

The nature of the relationship between this property and the taxpayer's "business operations" is the critical inquiry. The functional test focuses upon the role or function of the property as being integral to regular business operations.

(a) *"Acquisition, management, or disposition"*

"Acquisition, management, or disposition of property" establishes that the taxpayer must: (1) have some interest in and control over the property; (2) control or direct the use of the property; and (3) transfer, or have some power to transfer the property. Legal ownership or title to property is not necessary. Corporations often control and use property to generate business income without owning or holding legal title to the property. Consequently, the phrase "acquisition, management, or

disposition" encompasses the myriad of ways that corporations may control and use the rights and privileges commonly associated with ownership.

"Acquisition, management, or disposition of property" refers to a corporation's control and use of the property producing the income.

(a) "Integral," "regular," and "operations"

Second, the corporate taxpayer's control and use of the property must still be an "integral part[ ] of the corporation's regular trade or business operations[.]" The critical terms in this second key phrase of the functional test are ***"regular," "integral," and "operations."***

" *'[R]egular'* *trade or business* ***operations***"** refers to the normal or typical business activities of the corporate taxpayer. It is important to note that although "regular" has the same meaning in the transactional and functional tests, it is not used in the same way in these tests. In the transactional test – which focuses on the income-producing transaction –"regular" refers to the nature of the transaction. In the functional test –which focuses on the income-producing property –"regular" does not refer to the nature of the transaction. Therefore, the extraordinary nature or infrequency of the transaction is irrelevant. For example:

Under the functional test, business income includes income derived from isolated sales, leases, assignments, licenses, and other infrequently-occurring dispositions, transfers, or transactions involving property, including transactions made in liquidation or the winding up of business, so long as the property is or was used in the corporate taxpayer's trade or business. 103 KAR 16:060 §4(2)(a).

"[I]ntegral" then provides the touchstone for determining whether the property has a close enough relationship to the corporate taxpayer's to satisfy the functional test. "Integral" implies more than a mere contribution, but construing it as requiring the income-producing property to be necessary or essential is too restrictive. Rather, to be "integral" the property must be interwoven into the fabric of the taxpayer's business operations so that it becomes part of it in a manner that materially contributes to business income.

Property is an "integral part" if it constitutes a part of the composite whole of the trade or business, each part of which gives value to every other part, in a manner which materially contributes to the production of business income. 103 KAR 16:060 §1(6).

The regulation also creates a presumption that property is "integral" if the corporate taxpayer:

(1) Includes the original cost of the property in its apportionment factor; or
(2) Takes a deduction related to the property from business income apportioned to Kentucky; BUT
(3) the absence of either of these two actions does not create a presumption that the property is not integral.

There is a presumption that property meets the functional test as property "integral" to the taxpayer's trade or business if the taxpayer has included its original cost in the property factor or taken a deduction related to the property on the corporate return. However, the absence of either on the corporate return does not create a presumption that the property is not "integral." 103 KAR 16:060 §4(5).

Forming these interpretations of the second clause of the definition of "business income" into a cohesive whole:

Under the functional test, income is business income if the corporate taxpayer's acquisition, control, and use of the property from which the income is or was derived contributes materially to the taxpayer's production of business income.

The regulation provides the following additional rules:

#1 - Property converted to nonbusiness use by a corporate taxpayer will be deemed to have lost its character as a business asset after the passage of a sufficiently-lengthy period of time (generally, five (5) years),

BUT

#2 – Property that is or was an integral part of the trade or business will not be considered converted to investment property "merely because it is placed for sale." 103 KAR 16:060 §4(1)(b), (c).

#3 – Intangible assets such as patents, copyrights, trademarks, service marks, know-how, trade secrets, or the like, developed or acquired by the corporate taxpayer give rise to business income under the functional test. 103 KAR 16:060 §4(2)(b).

#4 – Partnership interests, and limited liability company membership interests may give rise to business income under either the transactional or functional test. 103 KAR 16:060 §6.

V. EXAMPLES

TAXATION BY APPORTIONMENT UNDER THE UNITARY BUSINESS PRINCIPLE

EXAMPLE NO. 1

Three railway companies organized under the laws of the State objected to its State law authorizing local jurisdictions to impose a property tax upon the value of their capital stock, franchises, and all their real and personal property. The system of taxation, which utilized a State "Board of Equalization," was to treat the railroad track, its rolling-stock, its franchise, and its capital, as a unit for taxation. The Board then distributed the assessed value of this unit to each local jurisdiction according to the length of the track in each county, city, and town bore to the whole length of the track.

The railway companies argued that:

(1) the valuation was made without regard to the value of such property separately;

(2) aggregating the value of the railway companies as a unit and then distributing to each local jurisdiction a portion of the whole resulted in the railway companies being taxed in one county on property owned in another; and

(3) this system violated the United States Constitution because it prescribed a different rule of taxation of railway companies from that for individuals.

This system worked an injustice, the railroads argued, because it subjected their track and franchise on the basis of a general value, to the taxation of the local jurisdictions without the benefit of using the rules of assessment utilized in each particular jurisdiction by the local assessors in valuing other similar property. In other words, that the local tax imposed by each local jurisdiction was not purely local.

The United States Supreme Court held:

It is obvious, while a fair assessment will include all the visible or tangible property of the corporation, this alone may not include all of its wealth. There may be other property of a class not visible or tangible which ought to respond to taxation and which the State has a right to subject to taxation. This element is what the State calls the value of the franchise and the capital stock of a corporation, that is, the value of the right to use this intangible property in a special manner for purposes of gain.

That the franchise, capital stock, and profits of all corporations are liable to taxation in the place where they do business, and by the State which creates them is undisputed. The privileges and franchises of a private corporation may be taxed by a State for the

support of a State government, in addition to other trades and avocations by which citizens acquire a livelihood.

But, it has been a desire by States to find a method of taxing this type of property which will at the same time be equal and fair, and which will enforce the just contribution that such property should pay for the benefits which the company receives at the hand of the government. We have seen on the whole no scheme which is better adapted to effect this purpose, so far as railway companies are concerned, of taxing at once all their property and of making the tax just and equal in its relation to other taxable property of the State. It is because in this case of the railway companies there is attached to all this property, and goes with it, a privilege, a right to use it through the whole extent of the richest counties in the State, in transporting persons and property in a manner which adds immensely to its value. By virtue of this privilege or franchise, this is all aggregated into a unit, well adapted to make money by its use in that way, with a chartered right to use it for that purpose. It is this franchise which the State intended to tax, which it has a right to tax, and in taxing it committed no injustice.

> "[A]s we have already said, a railroad must be regarded for many, indeed for most purposes, as a unit. The track of the road is but one track from one end of it to the other, and except in its use as one track, is of little value. In this track as a whole each county through which it passes has an interest much more important than it has in the limited part of it lying within its boundary. . . . It may well be doubted whether any better mode of determining the value of that portion of the track within any one county has been devised than to ascertain the value of the whole road and apportion the value in the county by its relative length to the whole."

State Railroad Tax Cases v. Miller, 92 U.S. 575 (1875) **(the United States Constitution does not require States to assess trackage in each county according to its value there; instead the State may ascertain the value of the whole road, and apportion the value within the county by its relative length to the whole).**

EXAMPLE NO. 2

The State passed certain laws providing for the taxation of telegraph, telephone, and express companies. A State created a board of appraisers and assessors, which was charged with the duty of assessing the property in Ohio of telegraph, telephone, and express companies. The taxable value of the companies was to be determined with reference to the value of the entire capital stock.

The taxpayers argued that although the assessments purported to be on their property within the State, the tax was in fact levied on their businesses, which were largely interstate commerce. Such a tax was a burden on interstate commerce and therefore violated the Commerce Clause of the United State Constitution.

The United States Supreme Court held:

Property belonging to corporations or companies engaged in interstate commerce may be directly subject to taxation without falling within the inhibition of the Constitution. Corporations and companies engaged in interstate commerce should bear their proper proportion of the burdens of the State governments under whose protection they conduct their operations, and taxation on their property does not affect interstate commerce other than incidentally, as all business is affected by the necessity of contributing to the support of government.

Telegraph and telephone companies, whose properties and businesses extend through several states, may be valued as a unit for the purposes of taxation, taking into consideration the uses to which the property is put and all the elements making up the aggregate value, and a proportion of the whole, fairly and properly ascertained, might be taxed by the State without violating any constitutional restriction. The valuation includes the proportionate part of the value resulting from the combination of the means by which the business was carried on, not merely the value of the tangible property such as wires, poles, and instruments of the telegraph company, or the roadbed, ties, rails, and spikes of the railroad company.

In addition, this same principle applies to the express companies, although there is no doubt that the physical unity that exists with the property of railway and telegraph companies does not also exist with express companies. Thus, the value of express companies is not limited to the horses, wagons, and furniture, but also includes the value associated with the use and management of those assets and capital necessary to carry on the business. While the unity which exists may not be a physical unity, it is something more than a mere unity of ownership; it is a unity of use, not simply for the convenience of profit, but for the very nature of the business. The property of an express company, distributed through different states, is an essential condition of the business united in a single specific use. It constitutes but a single enterprise, made so by the very character and necessities of the business.

Adams Express Company v. Ohio State Auditor, 165 U.S. 194 (1897) **(Apportionment can permissibly be applied to a multistate business lacking the "physical unity" of wires or rails but exhibiting the "same unity in the use of the entire property for the specific purpose" with "the same elements of value arising from such use.")**

EXAMPLE NO. 3

Taxpayer is a company engaged in the business of manufacturing typewriters and typewriter parts, in selling its products, and also certain accessories and supplies it purchases for resale, and in repairing and renting such machines. Its main office is in New York City. All manufacturing is done in the taxing state. It has branch offices in other states for the sale, lease, and repair of machines and the sale of supplies, and it has one such branch office in the taxing state. All articles made by it –and some articles purchased for resale –are stored in the taxing state until shipped directly to the branch offices, purchasers, or lessees.

The taxpayer argued that a tax on its net profits was imposed on income arising from business conducted beyond the borders of the taxing State, and therefore the tax was unconstitutional because it burdened interstate commerce and amounted to a taking of property without due process of law.

The United States Supreme Court held:

(1) the State's tax based on the net profits earned within the taxing State is valid although those profits may have been derived in part, or indeed mainly, from interstate commerce; and

(2) the taxpayer's objection that business outside the state is taxed rests solely upon the showing that of its net profits, the 47% apportionment derived from the apportionment of the net income is not reflective of the taxpayer's business in the State. But the taxpayer has failed to make such a showing. The profits of the corporation were largely earned by a series of transactions beginning with manufacture in the taxing State and ending with sale in other states. In this it was typical for a large part of the manufacturing business to be conducted in the taxing State. The legislature, in attempting to put upon this business its fair share of the burden of taxation, was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It therefore adopted a method of apportionment which, for all that appears in the record, reached and was meant to reach, only the profits earned within the State. The taxpayer carries the burden of showing that 47% of its net income is not reasonably attributable to its gross earnings derived after paying manufacturing costs. The corporation has not even attempted to show this, and

it appears that the net profits earned in the taxing State may have been much larger than 47%. Consequently, nothing in the record demonstrates that the method of apportionment adopted by the State is inherently arbitrary or its application to this corporation produced an unreasonable result.

***Underwood Typewriter Co. v. Chamberlain*,** 254 U.S. 113 (1920) **(extending the unitary business principle to justify taxation of net income by apportionment)**.

EXAMPLE NO. 4

A State's law provided that for the privilege of doing business in the State, a foreign manufacturing and mercantile corporation was to pay, in advance, an annual franchise tax, to be computed upon the net income of a corporation for the preceding year. This net income was "presumably the same" as that upon which the corporation was required to pay a tax to the United States. If the entire business of the corporation was not transacted within the State, the tax was based upon the portion of such ascertained net income determined by the proportion which the aggregate value of the assets within the State bore to the aggregate value of all such assets wherever located.

A British corporation, engaged in brewing and selling ale. All its brewing was done and a large part of its sales were made in England, but it imported a portion of its product to the United States which is sold through branch offices located in the State and other states. The corporation was assessed the franchise tax. It was an undisputed fact that the British corporation had no net income upon which it was subject to the United States federal income tax.

The corporation argued that the tax was not based upon any income derived from the business which it carried on in the State, but upon a portion of its net income derived from business carried on outside of the United State, in violation of the United States Constitution.

The United States Supreme Court held:

Since the British corporation carried on a unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in the taxing State and other places -- the process of manufacturing resulting in no profits until it ends in sales – the State is justified in attributing to it a just proportion of the profits earned by the corporation from such unitary business. The fact that the corporation may not have had any net income upon which it paid federal income tax does not show that it received no net income from the business which it carried on in the State.

Bass, Ratcliff, & Gretton v. State Tax Commission, 266 U.S. 271 (1924) **(extending the unitary business principle to justify taxation by apportionment of a franchise tax)**.

EXAMPLE NO. 5

In addition to a general corporate income tax, the State imposed a tax "for the privilege of declaring and receiving dividends, out of income derived from property located and business transacted in" the State. With respect to corporations transacting business within and outside the State, the income attributable to the State is calculated using the same formula as for the general corporate income tax, i.e. an apportionment formula. The State's Supreme Court had judged the tax as in violation of the United States Constitution with respect to a corporation transacting business in the State whose corporate headquarters were located outside the State, since the process for declaring the dividends and the details attending their distribution transpired outside the State.

The United States Supreme Court held:

"[T]he descriptive pigeon-hole into which a state court puts a tax" is of no importance in determining its constitutionality. For constitutional purposes, the decisive issue turns on the operating incidence of a challenged tax. The State is free to pursue its own fiscal policies, "unembarrassed" by the Constitution, if by the practical operation of the tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by being an orderly, civilized society. The sole test is whether the taxing power exerted by the State bears a fiscal relation to protection, opportunities and benefits given by the State.

State of Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1940) **(extending the unitary business principle to justify taxation by apportionment on the privilege of declaring dividends)**.

EXAMPLE NO. 6

The taxpayer, a multi-state enterprise, domiciled in Delaware. It conducted business in all 50 states and 22 foreign countries. Having started business in 1929 as a manufacturer of aviation and automotive parts, from 1970 through 1981, the taxpayer was organized in four major groups: automotive; aerospace/electronics; industrial/energy; and forest products. During the tax period, from December 1977 through November 1978, the taxpayer acquired a minority interest in a corporation that was one of the world's leading producers of nonferrous metals, treating ore taken from its own mines and ore it obtained from others. The taxpayer's acquisition was carried out through stock purchases on the open market. In the first half of 1981, the taxpayer sold its stock back to the corporation, generating a gain of $211.5 million.

Held: The United States Supreme Court held in part that so long as profits are income to the parent earned in a unitary business, then they may be subject to apportionability.

"For constitutional purposes capital gains should be treated as no different from dividends. [Instead] [o]ne must look principally at the underlying activity, not at the form of the investment, to determine the propriety of apportionability. Changing the form of the income works no change in the underlying economic realities of whether a unitary business exists, and accordingly it ought not to affect the apportionability of income the parent receives." (citations omitted)

Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768 (1992) **(extending the unitary business principle to justify taxation by apportionment of multistate enterprises capital gains).**

WHAT IS UNITARY?

EXAMPLE NO. 7

The taxpayer was a nationally known manufacturer of products made from grain corn. It manufactured starch, syrup, sugar, and their byproducts, feeds and oil. Its average yearly grind of raw corn during the tax period 1937 through 1942 varied from thirty-five to sixty million bushels. Most of its products were sold under contracts requiring shipment in thirty days at a set price or at market price on the date of delivery, whichever was lower. It permitted cancellation of such contracts, but from experience it could calculate with some accuracy future orders that would remain firm.

In 1934 and again in 1936 droughts in the corn belt caused a sharp increase in the price of spot corn. With a storage capacity of only 2,300,000 bushels of corn, a bare three weeks' supply, the taxpayer found itself unable to buy at a price which would permit its refined corn sugar, cerealose, to compete successfully with cane and beet sugar. To avoid recurrence of the situation, the taxpayer in 1937 began to establish a long position in corn futures as part of its corn buying program and as the most economical method of obtaining an adequate supply of raw corn without entailing the expenditure of large sums for additional storage facilities. At harvest time each year it would buy futures when the price appeared favorable. It would take delivery on such contracts as it found necessary to its manufacturing operations and sell the remainder in early summer if no shortage was imminent. If shortages appeared, however, it sold futures only as it bought spot corn for grinding. In this manner it reached a balanced position with reference to any increase in spot corn prices.

In 1940, the taxpayer netted a profit of $680,587 in corn futures, but in 1942 it suffered a loss of $109, 969. The taxpayer argued that its investment in the futures contracts were gains and losses of capital assets in its role as a "legitimate capitalist," which were separate and apart from its manufacturing operations. It denied that the corn future transactions were hedges or speculative dealing.

Was the income derived from the hedging transactions part of the taxpayer's unitary business?

Held: The United States Supreme Court held on these facts that nothing in the record supported the taxpayer's contention that the taxpayer's futures activity was separate and apart from its manufacturing operation. On the contrary, it appeared that the transactions were vitally important to the company's business as a form of insurance against increases in the price of raw corn. Not only were the purchases initiated for just that reason, but the taxpayer's sales policy, selling in the future at a fixed price or less, continued to leave it exceedingly vulnerable to rises in the price of corn. Further, the purchase of corn futures assured the company a source of supply which was admittedly cheaper than constructing additional storage facilities for raw corn. "Under

these facts it is difficult to imagine a program more closely geared to a company's manufacturing enterprise or more important to its successful operation."

In labeling its activity as that of a "legitimate capitalist" exercising "good judgment" in the futures market, the taxpayer ignores the testimony of its own officers that in entering the market the company was trying to protect a part of its manufacturing costs; that its entry was not for the purpose of speculating and buying and selling corn futures but to fill an actual need for the quantity of corn bought in order to cover what was expected to be able to be marketed over a period of fifteen or eighteen months. For tax purposes, the taxpayer's purchases constitute an integral part of its manufacturing business.

Corn Products Refining Company v. Commissioner of Internal Revenue, 350 U.S. 46 (1956) **(manufacturer's activity buying corn futures, accepting delivery in some cases and in other cases reselling the futures upon spot purchase of corn, constituted an integral part of its manufacturing business as it protected itself against the risk involved when the price of raw corn rose)**

EXAMPLE NO. 8

The taxpayer was a corporation organized under the laws of New York, where it had its principal place of business and its commercial domicile. It engaged in an integrated petroleum business, ranging from exploration for petroleum reserves to production, refining, transportation, and distribution and sale of petroleum and petroleum products. It also engaged in related chemical and mining enterprises. It conducted business in the taxing State, in over 40 other States, and in a number of foreign countries.

Much of the taxpayer's business abroad was conducted through wholly and partly owned subsidiaries and affiliates. Many of these were organized under the laws of foreign nations; a number, however, were domestically incorporated in States other than the taxing State. None of the taxpayer's subsidiaries or affiliates conducted business in the taxing State, and those corporations were controlled and managed elsewhere, from the headquarters in New York.

In the taxing State, the taxpayer's business activities were confined to wholesale in retail marketing of petroleum and related products. It had no oil or gas production refineries within the State. Although its business in the taxing State was by no means insignificant, it formed but a small part of the taxpayer's worldwide enterprise. The taxpayer's net income for the tax years included substantial amounts received as dividends from its subsidiaries and affiliates operating abroad. On its tax return, the taxpayer subtracted from its federal taxable income items it regarded as "nonapportionable," including the net dividends from its subsidiaries and affiliates.

The taxpayer argued that the income earned from its investments in affiliates and subsidiaries operating abroad was nonbusiness income not subject to tax under the United States Constitution.

Held: The United States Supreme Court held that a review of the taxpayer's corporate reports for the years in question, it was clear that many of these subsidiaries and affiliates, including the principal contributors to the taxpayer's dividend income, engaged in business activities that formed part of the taxpayer's integrated petroleum enterprise. The taxpayer had offered no evidence that would undermine the conclusion that most, if not all, of its subsidiaries and affiliates contributed to the taxpayer's worldwide petroleum enterprise. To carve out inccome as an exception to the general principle of apportionability, the taxpayer must demonstrate something about the nature of this income that distinguishes it from operating income, a proper portion of which the State may tax.

"[T[he linchpin of apportionability in the field of state income taxation is the unitary-business principle." In accord with this principle, what the taxpayer must show in order to establish that its dividend income is not subject to apportionment in the taxing State, is that the income was earned in the course of activities unrelated to the sale of petroleum products in that State. The taxpayer has made no effort to demonstrate that the foreign operations of its subsidiaries and affiliates are distinct in any business or economic sense from its petroleum sales activities in the taxing State. Indeed, all indications are that these foreign activities are part of the taxpayer's integrated petroleum enterprise. In the absence of any proof of a discrete business enterprise, the taxing State is entitled to conclude that the dividend income's foreign source did not destroy the requisite nexus with the in-state activities. So long as dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise, those dividends are income the parent earned in a unitary business. While superficially inter-corporate division (i.e. subsidiaries as opposed to mere divisions) may be an attractive basis for limiting apportionability, the form of the business may have nothing to do with the underlying unity or diversity of the business enterprise. Had the taxpayer chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that income derived from these divisions would be business income. "Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not affect the apportionability of income the parent receives."

Mobil Oil Corporation v. Commissioner of Taxes, 445 U.S. 425 (1980) **(the taxpayer has the burden of establishing that any "foreign source" dividend income received from subsidiaries and affiliates is not business income in the taxing State by demonstrating the income was earned in the course of activities unrelated to the corporation's activities in the taxing State).**

EXAMPLE NO. 9

The taxpayer, organized under the laws of Deleware, was a vertically integrated petroleum company doing business in several States. Its general offices were located in Houston, Texas. During the tax years in question, the taxpayer's corporate organization structure consisted of three parts: Corporate Management, Coordination and Services Management, and Operations Management.

Corporate management was the highest order of management for the entire corporation, and it consisted of the board of directors, the executive committee, the president, and various directors-in-charge who were on the board of directors. **Coordination and Services Management** was composed of corporate staff departments which provided specialized corporate services. These services included long-range planning for the company, maximization of overall company operations, development of financial policy, financing, accounting, legal advice, labor and public relations, purchase and sale of raw crude oil and raw materials, and coordination between the refining and other operating functions.

The third level of management, **Operations Management,** was responsible for directing the operating activities of the functional departments of the company. These departments were: Exploration and Production, Refining, Marketing, Marine, Coal and Shale Oil, Minerals, and Land Management. Each functional department was organized as a separate unit operating independently of the other operating segments, and each had its own separate management. These departments were treated as separate investment centers by the company, and a profit was determined for each one. Each department was independently responsible for its performance. This arrangement permitted centralized management to evaluate each operation separately. Each department was therefore required to compete with the other departments for available funds, as well as with other members of the industry performing the same function, for the company's raw materials and refined products.

Transfers of products and raw materials among the three major functional departments – Exploration and Production, Refining, and Marketing – were theoretically based on competitive wholesale market prices. Separate functional accounting was used which treated transfers of crude oil from Exploration and Production to Refining as sales at posted industry prices; transfers of products from Refining to Marketing were also based on wholesale market prices. If no readily available wholesale market value existed, representatives of the two departments involved would negotiate as to the appropriate internal transfer value.

The taxpayer had no exploration and production operations or refining operations in the taxing State. The only activity carried on there was marketing. The marketing district in the State reported to a central regional office located outside the State, and that office in turn reported to the Marketing Department headquarters in the Houston office.

The motor oils and other packaged materials sold by the taxpayer in the taxing State were manufactured outside the State and shipped in. Tires, batteries, and accessories sold in the State were centrally purchased through the Houston office and shipped to the State. The gasoline sold in the State was not produced by the taxpayer, but rather obtained from a competitor under an exchange agreement.

The taxpayer used a nationwide credit card system, which was administered out of the national headquarters in Houston. Uniform packaging and brand names were used, and the overall plan for distribution of products was developed in Houston. Promotional display equipment was designed by the engineering staff in Houston.

The taxpayer prepared its tax returns to the taxing State based upon separate State accounting methods, which reflected only the marketing operation in the State. The taxpayer's position was that the State could only properly apply its apportionment statute to its Marketing Department income as established by its separate functional accounting. The State's department of revenue assessed the taxpayer for additional taxes based on the company's total income, determining that the marketing operations carried on in the State were an integral part of one unitary business, regardless of the separate functional accounting.

Held: A company's internal accounting techniques are not binding on a State for tax purposes. The company had the distinct burden of showing by clear and cogent evidence that the apportionment formula results in extraterrestrial (i.e. out-of-State) values being taxed. The taxpayer's accounting evidence is insufficient to meet that burden.

Separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Since these factors arise from the operation of the business as a whole, it is misleading to characterize the income of the business as having a single identifiable source. Although separate geographical or as in this case, functional accounting may be useful for internal company purposes, it is not a determining factor for purposes of state taxation.

In order to exclude certain income from the apportionment formula, the company must prove that the income was earned in the course of activities unrelated to the sale of petroleum products in the State. The court looks to the underlying economic realities of a unitary business, and the income must derive from unrelated business activity which constitutes a discreet business enterprise. While the taxpayer here may treat its operational departments as independent profit centers, it is nonetheless true that this case involves a highly integrated business which benefits from an umbrella of centralized management and controlled interaction.

***Exxon Corporation v. Wisconsin Department of Revenue*, 447 U.S. 207 (1980) (taxpayer's "functional accounting" separating income into three distinct categories of marketing, exploration and production, and refining, does not foreclose a State's ability to tax the total income under its apportionment formula of a unitary business)**

EXAMPLE NO. 10

The taxpayer produced approximately 60,000 items, which can roughly be classified into three categories: (1) consumer products, (2) electrical and electronic products including lighting products, and (3) technical and scientific products. Its operations in Kentucky were limited to operating a plant in Harrodsburg operating ophthalmic lenses used in eyeglasses, and a plant in Danville producing fluorescent tubing and some photo-flash tubing. The products were complete and were thereafter sold directly from the Kentucky plant to customers. Because of the direct sales from products manufactured in Kentucky, the taxpayer maintained that its income from the Kentucky operations could be readily ascertained and separated from the total of all the taxpayer's income.

The income in question is from several sources. Capital gains income was from "know-how" sales to Hungary and Romania. The taxpayer assisted in the construction and operation of a light bulb plant in Romania and a television plant in Hungary. These activities were "once-in-a-lifetime" arrangements. Other capital gains were derived from a sale of a business making glass panes to fit over fluorescent bulbs which was determined not to fit into the taxpayer's operation; the sale of one of its subsidiaries, an Australian corporation; sales of government bonds, the sale of a plant in New Jersey, and the contribution of shares of a fiberglass company and leasehold property to the employees' pension fund.

Royalty income had been derived from licensing fees for patents and "know-how" involving products not related to those sold in Kentucky. These patents, etc. were developed in the taxpayer's research and development plant in New York. The royalties were paid from Japanese, British, and German corporations not related to the taxpayer.

Interest income had been received as a result of the investment of surplus funds pending a decision on how the funds should be used in the business. The interest was derived from short-term loans and loans to subsidiaries and related corporations.

The taxpayer commingled all of its income treated as business income.

The Kentucky Court of Appeals held:

> "The law is quite clear. A multi-state corporation with income from business activity in several states must allocate and apportion to Kentucky

> a fraction of its net business income. The law no longer requires that taxable net income have an identifiable source within this State. The apportionment formula has been generally accepted and is a fair allocation of all income which runs afoul of no constitutional safeguard.
>
> The activities of a corporation will be considered a single unitary business, it there is evidence to indicate that the operations of its divisions are integrated with, dependent upon, or contribute to each other and the operations of the taxpayer as a whole."

In this case, the short term loans and other loans to subsidiaries and related companies discloses that there is an interdependence between interest income and the business of the taxpayer, and therefore it is business income. Moreover, the capital gains income was received from property used by the corporation to produce business income. The sales, therefore, were in the regular course of the taxpayer's trade or business. Finally, the royalty income from patents and "know-how" developed in the New York operation constitute an integral part of the taxpayer's business operations. The taxpayer grants permits to others to use the patents for which it receives income in the regular course of its business. While it may be that not all the income is necessarily subject to taxation by Kentucky, the burden is on the taxpayer to show how the questioned income was not derived in the regular course of business, which it has not done here.

Corning Glass Works v. Department of Revenue, 616 S.W.2d 789 (Ky. App. 1981) **(activities of a corporation will be considered a single unitary business for tax purposes if there is evidence to indicate that the operations of its divisions are integrated with, dependent upon, or contribute to each other and the operations of the taxpayer as a whole).**

EXAMPLE NO. 11

The taxpayer was in the business of manufacturing custom-ordered paperboard packaging. Its operation was vertically integrated, and included the production of paperboard from raw timber and wastepaper as well as the composition into the finished products ordered by customers. The operation was also largely within the United States. The taxpayer controlled 20 foreign subsidiaries located in Latin America and European countries. Its percentage ownership of the subsidiaries (either directly or through other subsidiaries) ranged between 67% and 100%. In those instances (about one-half) in which the taxpayer did not own a 100% interest in the subsidiary, the remainder was owned by local nationals. One of the subsidiaries was a holding company that had no payroll, sales, or property, but did have book income. Another was inactive. The rest all engaged –in their respective local markets – in essentially the same business as the taxpayer.

Most of the taxpayer's subsidiaries were, like itself, fully integrated, although a few bought paperboard and other intermediate products elsewhere. Sales of materials from

appellant to its subsidiaries accounted for only about 1% of the subsidiaries' total purchases. The subsidiaries were also relatively autonomous with respect to matters of personnel and day-to-day management. For example, transfers of personnel from the taxpayer to its subsidiaries were rare, and occurred only when a subsidiary could not fill a position locally. There was no formal United States training program for subsidiary employees, although groups of foreign employees occasionally visited the taxpayer for a period of 2 to 6 weeks to familiarize themselves with the taxpayer's methods of operation. The taxpayer charged one senior vice-president and four officers with the task of overseeing the operations of subsidiaries. These officers established the general standards of professionalism, profitability, and ethical practices and dealt with major problems and long-term decisions; day-to-day management of the subsidiaries however, was left in the hands of the local executives who were always citizens of the host country. Although local decisions regarding capital expenditures were subject to review by the taxpayer, they were generally worked out by consensus rather than outright domination. The taxpayer also had a number of its directors and officers on the boards of directors of the subsidiaries, but they did not generally play an active role in management decisions.

Nevertheless, in certain respects, the relationship between the taxpayer and its subsidiaries was decidedly close. For example, approximately half of the subsidiaries' long term debt was either held directly, or guaranteed, by the taxpayer. The taxpayer also provided advice and consultation regarding manufacturing techniques, engineering, design, architecture, insurance, and cost accounting to a number of its subsidiaries, either by entering into technical service agreements with them or by informal arrangement. Finally, the taxpayer occasionally assisted its subsidiaries in their procurement of equipment, either by selling them used equipment of its own, or by employing its own purchasing department to act as an agent for the subsidiaries.

The taxpayer included only its own corporate net earnings in its tax return to the taxing State, but did not include any income of its subsidiaries. The taxing State assessed the taxpayer for additional income. **The question was whether the taxpayer should have treated its overseas subsidiaries as part of its unitary business rather than as passive investments.**

The United States Supreme Court held:

The taxpayer's argument that the State improperly relied on the the taxpayer's mere *potential* to control the operations of its subsidiaries in reaching its unitary business finding is unfounded. In fact the State relied principally, in discussing the management relationship between the taxpayer and its subsidiaries, on the more concrete observation that "high officials of [the taxpayer] gave directions to subsidiaries for compliance with the parent's standard of professionalism, profitability, and ethical practices."

The State did not err in endorsing an administrative presumption that corporations engaged in the same line of business are unitary. This presumption did enter into the State's reasoning, but only as one element among many. When a corporation invests in a subsidiary that engages in the same line of work as itself, it becomes much more likely that one function of the investment is to make better use – either through economies of scale or through operational integration or sharing of expertise – of the parent's existing business-related resources.

Finally, the Court declined to adopt a bright-line rule requiring as a prerequisite to a finding that a mercantile or manufacturing enterprise is unitary that it be characterized by "a substantial flow of goods." The prerequisite to a constitutional finding of unitary business is a flow of *value* , not a flow of goods. A relevant question in the unitary business inquiry is whether contributions to income of the subsidiaries resulted from functional integration, centralization of management, and economies of scale. Substantial mutual interdependence can arise in any number of ways; a substantial flow of goods is clearly one, but just as clearly not the only one.

The State relied on a large number of factors in reaching its judgment that the taxpayer and its foreign subsidiaries constituted a unitary business. These include the taxpayer's assistance in obtaining used and new equipment and in filling personnel needs that could not be met locally, the substantial role played by the taxpayer in loaning funds and guaranteeing loans to subsisidiaries, the considerable interplay between the taxpayer and its foreign subsidiaries in the area of corporate expansion, the substantial technical assistance provided by the taxpayer to the subsidiaries, and the supervisory role played by the taxpayer's officers in providing general guidance to the subsidiaries. These factors present a "functionally integrated enterprise, which the State is entitled to tax as a single entity. There is no need to decide whether any one of these factors would be sufficient to prove the existence of a unitary business. Taken in combination, they clearly demonstrate that the State reached a conclusion "within the realm of permissible judgment."

***Container Corporation of America v. Franchise Tax Board*,** 103 U.S. 159 (1983) **(the prerequisite to a constitutionally acceptable finding of a unitary business is a flow of *value*, not a flow of goods (flow of goods is but one way to demonstrate substantial mutual interdependence); the relevant question is whether contributions to income of the foreign subsidiaries resulted from functional integration, centralization of management, and economies of scale; presumption that corporations engaged in the same line of business are unitary is reasonable)**

EXAMPLE NO. 12

The taxpayer, a multi-state enterprise, is domiciled in Delaware. It conducted business in all 50 states and 22 foreign countries. Having started business in 1929 as a manufacturer of aviation and automotive parts, from 1970 through 1981, the taxpayer was organized in four major groups: automotive; aerospace/electronics; industrial/energy; and forest products. During the tax period, from December 1977 through November 1978, the taxpayer acquired a minority interest in a corporation that was one of the world's leading producers of nonferrous metals, treating ore taken from its own mines and ore it obtained from others. The taxpayer's acquisition was carried out through stock purchases on the open market. In the first half of 1981, the taxpayer sold its stock back to the corporation, generating a gain of $211.5 million.

The question was whether the income derived from the sale of the stock was business income and therefore subject to the State's tax. The State's theory was that any multistate corporation doing business in the State subjects all of its out-of-state income to apportionment.

Held: The United States Supreme Court held that the State's theory that the income attributable to the sale of stock is business income because a multistate corporation like the taxpayer regards all its holdings as a pool of assets used for maximum long-term profitability is not sustainable. While the taxpayer probably cares most about profits appearing on the financial statement, that state of mind sheds little light on the question asking whether in pursuing maximum profits the taxpayer a treated particular intangible asset as serving, on the one hand, an investment function, or on the other, an operational function. The relevant unitary business inquiry is one which focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State.

In this case, the taxpayer and the corporation in which it owned stock it later sold were not engaged in the same line of business. However, it is not necessary that the "payor" and the "payee" be engaged in the same "unitary" business to find a unitary relationship exists. Rather, what is required is that the capital transaction serve an operational rather than an investment function. To be sure, the existence of a unitary relation between the payor and the payee is one means of meeting the unitary business requirement. However, there is no general requirement that the payor and the payee have a unitary relationship to justify apportionment. For example, a State may include as apportionable income of a multistate corporation the interest earned on short-term deposits in a bank located in another State if that income forms part of the working capital of the corporation's unitary business, notwithstanding the absence of a unitary relationship between the corporation and bank. That circumstance is not present in this case.

The three factors upon which to focus are not present in this case. The stipulated facts show that functional integration and economies of scale could not exist because the taxpayer and the corporation in which it held the stock "were unrelated business enterprises each of whose activities had nothing to do with each other." Moreover, because the taxpayer owned only 20.6% of the stock, it did not have the potential to operate the corporation as an integrated division of a single unitary business. Furthermore, the mere fact that an intangible asset was purchased to pursue a long-term strategy of acquisitions and dispositions does not convert an otherwise passive investment into an integral operational one.

Also, the fact that a transaction was undertaken for a business purpose does not change its character from, for example, a passive function into an operational function. The hallmarks of an acquisition that is part of a taxpayer's unitary business continue to be functional integration, centralization of management, and economies of scale. These essentials could respectively be shown by: transactions not undertaken at arms-length; a management role by the parent that is grounded in its own operational expertise and strategy; and the fact that the corporations are engaged in the same line of business. It is undisputed that none of these circumstances existed in this case.

Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768 (1992) **(the hallmarks of an acquisition that is part of a taxpayer's unitary business are: functional integration, centralization of management, and economies of scale; even in situations where the "payee" and the "payor" are not engaged in the same unitary business, an asset can form part of a taxpayer's unitary business if it served an operational rather than an investment function).**

EXAMPLE NO. 13

The taxpayer was an Ohio corporation in the business of producing and selling paper, packaging, and school and office supplies. In 1968, the taxpayer purchased a company which owned an inkjet printing technology and a full-text information retrieval system. The taxpayer was interested in the inkjet printing technology because it would have complemented its paper business, but in actuality, the information retrieval system proved to be the more valuable asset. Over the course of many years, the taxpayer developed that asset into an electronic research service. In 1994, the taxpayer sold the company, realizing over one billion dollars in capital gain. The taxpayer used the gain to repurchase its own stock, retire debt, and pay taxes. The taxpayer did not report any of this gain as business income to the taxing State, taking the position that the income attributable to the sale of the company was nonbusiness income properly allocated to its domiciliary State of Ohio. The taxing State assessed the taxpayer approximately four million dollars in additional tax. The taxpayer paid the tax and sued the State for a refund.

Based upon the facts presented at the trial, the State's lowest court found the company was not unitary with the taxpayer. However, the State's appellate court concluded that the State could tax an apportioned share of the capital gain because the company "served an 'operational purpose'" in the taxpayer's business. The State's highest court affirmed. The United States Supreme Court granted the taxpayer's petition for certiorari.

Held: The United States Supreme Court held that the State's appellate court had made a fundamental error in its reasoning when it determined the company served an "operational purpose" in the taxpayer's business after first determining that the taxpayer and the company were not unitary.

The concept of "operational function" is not a new ground for apportionment. Instead, the concept of "operational function" simply recognizes that an asset can be a part of a taxpayer's unitary business even if what we may term a "unitary relationship" does not exist between the "payor" and the "payee."

In the example given in the Allied-Signal case, the taxpayer was not unitary with its banker, but the taxpayer's deposits (which represented working capital and thus operational assets) were clearly unitary with the taxpayer's business. In the Corn Products case, the taxpayer was not unitary with the counterparty to its hedge, but the taxpayer's futures contracts (which served to hedge against risk of an increase in the price of a key cost input) were likewise clearly unitary with the taxpayer's business. In each case, the "payor" was not a unitary part of the taxpayer's business, but the relevant asset was. The conclusion that the asset served an operational function was merely instrumental to the conclusion that the asset was a unitary part of the business being conducted in the taxing State. The term "operational function" is used in the context of the unitary business principle; it is not a separate test granting a new ground for apportionment of out-of-state values.

In this case the trial court found the hallmarks of a unitary relationship (i.e. functional integration, centralized management, and economies of scale) were lacking between the company and the taxpayer. However, the appellate courts made no such determination, instead relying upon what they believed was a separate test for "operational function." The Court remanded the case to the State's appellate court to revisit the question asking whether the trial court had properly determined the taxpayer and the company were not unitary.

Meadwestvaco Corporation v. Illinois Department of Revenue, 553 U.S. 16 (2008)**, (once the State courts determined that the multistate enterprise and the business division that it had sold for a capital gain, did not constitute a unitary business, they should not have proceeded to question further whether this business division served an operational function in the multistate enterprise's business)**